11/17/2000 11:51 AM - DRAFT FDIC STAFF MEMORANDUM
HOW TO AVOID PURCHASING OR INVESTING IN PREDATORY MORTGAGE LOANS
NOVEMBER 2000

Part One: Purpose and Introduction

This memorandum provides suggestions on how to avoid purchasing or funding predatory mortgage loans and investing in securities backed by such loans. These activities may be the most common means by which financial institutions and other investors unknowingly help to fund predatory loans, incurring several risks.

Predatory loans harm individuals and communities, raising compliance concerns for financial institutions. Predatory loans can have a negative impact on a bank's Community Reinvestment Act evaluation. The loans may violate fair lending laws and other consumer protection laws, resulting in legal or regulatory action. Questionable loan underwriting and the risk of litigation also raise safety and soundness concerns. For these reasons, we seek ways to help institutions avoid these risks.

Part Two of this memorandum sets out a series of steps in a checklist format financial institutions can use when considering loan purchases to help identify whether they may be purchasing predatory loans. To increase efficiency and minimize burden, the steps are arranged in a graduated workflow. The initial steps may provide sufficient information to make a decision about loan purchases; if not, then an institution may decide to follow the subsequent steps. Part Three of the memorandum provides a similar checklist for the purchase of asset-backed securities.

Predatory loan characteristics

Predatory loan characteristics and practices are well known:

- Misleading or fraudulent marketing
- Loan fees and interest rates higher than necessary to cover profit and risk
- Excessively priced products, such as single premium credit life insurance
- Large prepayment penalties that make it difficult to refinance affordably
- Balloon payments likely to result in default and foreclosure
- Abusive collection and aggressive foreclosure practices
- Mandatory arbitration provisions

- Underwriting based on the value of collateral rather than a borrower's ability to repay

This guidance suggests steps to identify some of these characteristics. While a few occurrences of these characteristics in a package of loans may not indicate a pattern of predatory lending, several occurrences may raise concern, depending on the circumstances surrounding the loans.

Subprime vs. Predatory: a risk-based focus

Although not all victims of predatory lending practices are subprime borrowers, predatory lenders may target subprime borrowers because they are often more vulnerable and have fewer alternatives than other borrowers. This memorandum is not intended to discourage the purchase of properly underwritten and appropriately priced subprime loans or securities backed by such loans. On the contrary, the FDIC believes safe and sound, well-managed subprime lending programs, with appropriate capitalization and loan pricing, provide an important source of credit for borrowers whose credit history may not permit them to qualify for the conventional "prime" loan market.

Nevertheless, a risk-based review for predatory loans by financial institutions makes sense. This guidance suggests a focus, first, on loan originators with a reputation for engaging in predatory lending. It then suggests focusing on a category of loans most likely at risk of exhibiting predatory characteristics, such as subprime loans or other lending targeted to under-served areas often victimized by predatory lenders.

About this guidance

Even the best-intentioned banks can become associated with predatory lending, inadvertently, through involvement in the mortgage and securities markets. Some banks purchase loans from loan brokers. Others have lending subsidiaries, form joint ventures with other lenders, or provide warehouse lines of credit, liquidity facilities, and dealer or broker lines. Some banks or their subsidiaries may service loans. In addition, some banks might invest in asset-backed securities or participate in the securitization process by providing trust services or acting as an underwriter.

The advice in this memorandum focuses on loan purchases and investments in securities, those parts of the mortgage market that pose the most common risk to institutions. However, the underlying principles also apply to other ways banks may be involved in the mortgage market. Each bank needs to decide for itself precisely how and to what extent it will undertake due diligence to minimize the risk of involvement in predatory loans. We seek public comment on this approach and how to avoid unknowingly purchasing or investing in predatory loans without disrupting housing markets.

Part Two: How to Avoid Purchasing Predatory Loans

Three important areas to review when purchasing or funding whole loans are the reputation of the originators, including brokers, the characteristics of the loans, and the quality of the underwriting process.

The due diligence process described in this section minimizes unnecessary burden by organizing risk factors into three steps. Step One examines risk factors relating to the loan originators or brokers. If any risk is identified in Step One that requires additional examination, then Step Two suggests further due diligence with respect to the originators' underwriting and compliance programs. If concerns remain and a decision on a purchase cannot be reached, a review of the loans underlying the transaction, as outlined in Step Three, may be appropriate.

Step One: Learn about the Originators

Certain lenders and brokers are more likely to engage in predatory practices than others. As a first step, ask about the originators and their practices. If you have an existing relationship with a particular originator, you may already have sufficient information at your disposal. However, if considering a relationship with a subprime originator whose records are not known to you, consider asking about:

✔ *Marketing tactics:* Ask about the originator's sales and marketing activities. Look for inaccurate, misleading, or aggressive sales or marketing practices. You may also want to talk to organizations such as the local Better Business Bureau, legal aid society, and fair housing or affordable housing groups about the lender.

✔ *Complaints and litigation:* Inquire about litigation and complaints against the loan originator. Consult with states' attorneys-general and federal, state or local consumer protection agencies, and fair housing agencies from areas where the loans were originated. A pattern of consumer complaints about incorrect disclosures, unfair or deceptive practices, or excessive collection and aggressive foreclosure activities should raise concern.

✔ *Use of brokers:* Ask about the extent to which any lender uses brokers to generate customers. Ask about the due diligence of the lender when establishing relationships with brokers. Inquire about the extent brokers receive yield spread premiums for loans they bring to the lender and whether those same loans have prepayment penalties.

You may gather sufficient information to decide whether to purchase the loans or establish the broker relationship and end the due diligence review at this stage. However, in some cases, a concern may surface which by itself does not necessarily indicate predatory practices but may raise questions that warrant a closer review, such as outlined in StepTwo.

Step Two: Review Underwriting and Compliance Programs

A basic understanding of the originator's underwriting policies and practices is advisable if you have questions about the lender, its use of brokers, or complaints and litigation. In reviewing its underwriting and compliance programs, find out about:

✔ *Loan underwriting:* Ask about the originating lender's underwriting guidelines and loan processing procedures. Do the underwriting policies permit practices that raise predatory lending "red flags"? To what extent are the actions of loan officers or brokers monitored?

✔ *Loan delinquencies and defaults:* Examine the rates of loan delinquencies and defaults on previous loans made by the originator. Higher rates of default – relative to comparable subprime loans – could be an indication the originator does not adequately account for a borrower's ability to repay when making a loan, which is characteristic of loans based on collateral value rather than ability to repay.

✔ *Compliance programs:* Determine whether originators implement policies conforming to TILA, HOEPA, RESPA, FHAct, and ECOA's regulations. Review those policies to see if they measure up to the policies at your organization. Ask also about the level of training provided to staff on these important regulations.

If any of these risk factors raise unresolved questions, and a decision to complete the transaction cannot be reached, Step Three suggests additional due diligence.

Step Three: Review a Sample of Loan Files

Focus attention on a sample of refinanced loans and loans with excessively high interest rates, points, and fees. Although not all such loans are predatory, predatory loans often exhibit those characteristics. Look to see whether there is evidence of collateral-based lending, particularly instances of loans with a low ratio of loan-to-value made to borrowers with poor credit history or excessive debt. Check also for borrowers who appear to qualify for prime loans, but who received loans at subprime interest rates. Ask about:

✔ *Loan terms and conditions:* Look for indicators of potential predatory lending – particularly in combination – such as:

- ➢ *Fees and interest rates:* Question any that are well beyond those appropriate or necessary to cover both risk and a profitable return. While there are no hard rules with respect to what level of fees and interest is predatory, experienced lenders should be able to recognize questionable fees and excessive rates.

- *Excessively priced products*: Inquire why these may exist. Ask whether any may be included in the loan balance, such as single-premium credit life insurance.

- *Large prepayment penalties:* Look for penalties that would make it difficult for borrowers to refinance unaffordable loans.

- *Certain balloon payments:* Determine whether any loans have unrealistic repayment terms, particularly balloon payments due in a relatively short period of time, thus increasing the likelihood of default or foreclosure.

✔ *Loan documents and disclosures:* Compare the documents to the lenders' written policies, as well as to regulatory requirements. Inspect documents and policies for possible signs of predatory characteristics, such as:

- *Incomplete disclosures*: Check to see that the additional required disclosures for loans covered by the Home Ownership and Equity Protection Act (HOEPA) were accurate and provided at least three days before the loan was signed. Consumers should be aware of their right to reconsider a ‘high cost’ mortgage, to escape unfavorable mortgage loans before it is too late.

- *Bait and switch fees:* Compare the HUD-1 settlement statement with the Good Faith Estimate issued at application. Pay particular attention to any substantial variations in the fees charged which may indicate a deceptive practice.

- *Add-on fees:* Review the originator's fees, particularly commission-based fees and discretionary overages. Such fees invite abuse when they are not limited or monitored. Pay particular attention to loans in which a yield spread premium was paid to a loan broker.

- *Loan flipping:* Review title insurance policies for the date of last recording of a mortgage. Numerous mortgages within a short period may indicate "flipping", a predatory practice involving frequent refinancing in which fees are folded repeatedly into the transactions resulting in higher balances, "equity stripping," and more likely default and foreclosure.

✔ *Safety and soundness aspects:* Review underwriting procedures and collateral requirements. For example:

- *Ability to repay:* Verify the borrower's ability to repay. Review debt-to-income ratios, including front-end and back-end ratios. Check to see that verifiable sources of income are maintained in the loan file, such as W-2 forms, employment verifications, and other verifiable sources of income for those who are retired or receive government assistance. Loans not based on the ability to repay, that are collateral-based, may raise the question of abusive foreclosure and asset-recapture practices.

- *Escrows:* Determine whether there is an escrow account for taxes and insurance. Some predatory lenders do not establish escrows. When borrowers do not have funds to pay these bills, they are induced to refinance, thereby creating another opportunity for the lender to add on fees and strip equity.

- *Appraisals:* Ensure the collateral was appraised fairly and accurately. Be wary of drive-by appraisals on high LTV loans intended to facilitate a loan that would not make sense for a borrower or lender other than for the originator to extract high fees and interest or to capture the property.

- *Fraud:* Look for indicators of potential fraud. Mismatched signatures within a loan file, look-alike signatures in multiple files, and duplicate non-wage income verification in multiple files should be reviewed closely as they may indicate fraud.

Part Three: How to Avoid Investing in Securities Backed by Predatory Loans

Loans included in mortgage-backed or other asset-backed securities are typically subject to due diligence by the securities underwriter before the securities are created. Generally, the underwriter reviews loan origination documents, loan payment terms, and borrower characteristics on a sample group of loans. The underwriter also performs due diligence on the loan originator by reviewing its underwriting practices and policies. Some of the results of the underwriter's due diligence is communicated directly to potential purchasers through the offering circular or prospectus used to market the securities.

The federal securities laws require underwriters to disclose in the prospectus material information about the underlying characteristics of the loans in a securitization transaction. In general, the prospectus describes the structure and payment terms of the securities offered for sale, provides information about the type of credit enhancement, and summarizes characteristics of the underlying loans, including loan balance, maturity date, loan-to-value ratios, interest rate, adjustable-rate index type, margin, geographic location and loan purpose.

Following are steps financial institutions can take to evaluate the overall mortgage-backed security structure to help determine if the underlying loan origination programs and policies of the issuer indicate possible predatory lending practices.

Step One: Know the issuer

Most issuers of mortgage-backed securities are not first-time securitizers. By requesting information about past securitization transactions involving the same loan originator, financial institutions may be able to discern information about the issuer's reputation, particularly the performance of past securitizations. Specifically, you may want to find out about:

✔ *The reputation of the originating lender:* Loan conduits and mortgage-backed security issuers often enter into loan purchase arrangements with loan brokers and correspondents. Inquire of the underwriter whether complaints or lawsuits have been filed against the originator of the mortgages for predatory lending practices. Assess the extent to which the originator relies on brokers.

✔ *Past performance:* Ask the underwriter about prepayment speeds, delinquency and loss rates of existing securitization transactions that include loans from a particular originator. The rating agencies review such factors to set the initial credit enhancement level. Higher prepayments, delinquencies and loss severity may indicate that the loan originator has gone beyond its normal marketing practices, targeting more susceptible borrowers.

✔ *Changes in ratings:* Ask the underwriter about upgrades or downgrades of previous securitizations issued by a particular originator. Securitizations with downgraded ratings usually include loans that are not performing as originally expected by the rating agencies at the time of the initial rating.

Step Two: Review the Prospectus and Prospectus Supplement

A careful reading of the prospectus, or a prospectus supplement, which contains additional information, representations and warranties, may indicate that some of the underlying loans have predatory characteristics. The indicators are unlikely to be definitive, but they may alert you to the possibility of predatory loans backing the securities. Consider:

✔ *Representations:* Ensure that the prospectus represents that the underlying loans were made in compliance with all applicable federal and state consumer protection and fair lending laws and regulations, including TILA, HOEPA, RESPA, FHAct, and ECOA.

✔ *Underlying loan characteristics:* Although no individual characteristics clearly identify predatory loans, certain combinations of characteristics may raise predatory lending "red flags." Examples of information to review in tandem are:

- *Loan purpose:* Review the pool distribution of refinances and equity takeouts. Although refinancing a loan is not by itself an indication of a predatory loan, some brokers engage in "loan flipping" which is the practice of repeatedly refinancing a mortgage loan without benefit to the borrower. If there is a high percentage of refinanced loans, ask the underwriter to explain.

- *Loan-to-value ratios:* A mortgage pool with a high percentage of low loan-to-value ratios and a high percentage of loans with a high debt-to-income could be a sign that borrowers with significant home equity may be unnecessarily refinancing loans. Uninformed borrowers could enter into loans with payment terms that are not affordable out of current income.

- *FICO scores:* Review the distribution of loans with unusually low FICO scores. While many lenders use FICO scores to help them make lending decisions, each lender has its own strategy; consequently, no single "cutoff score" is used by all lenders. Pools with a high percentage of loans with lower FICO scores but relatively low loan-to-value ratios may indicate loan originators are targeting vulnerable borrowers.

✔ *Loan features:* Scrutinize loan features to determine if any exhibit predatory characteristics, including interest rates, fees, and prepayment penalties. Consider, for example:

- *Loan distribution:* Review the distribution of loans with excessively above-market interest rates underlying so-called "targeted" mortgage-backed securities. In particular, review such mortgage-backed securities with underlying loans targeted to specific low- and moderate-income or minority areas, which may be at risk.

- *Prepayment penalties*: Review the percentage of loans in the pool subject to prepayment penalties. Prepayment penalties can inhibit borrowers from refinancing at lower interest rates. Predatory lenders may invoke overly stringent penalties for this reason. Ask the underwriter whether a review of the penalties raised questions.

- *Adjustable rate loan features:* Review mortgage pools with a large percentage of adjustable interest rate margins over the norm (e.g., six percent) or with unusual interest rate indices. When interest rates adjust, borrowers may have a difficult time paying the new higher interest rate. Compare the maximum lifetime interest rate distribution to the current interest rate distribution to determine whether future interest rates could rise significantly above initial low “teaser” rates, increasing the possibility of default and foreclosure for vulnerable borrowers.

- *Negative amortization:* Review whether loans in the pool are subject to negative amortization.

Step Three: Review credit enhancement requirements

In publicly offered securitization transactions, underwriters obtain credit ratings from one or more rating agencies for each class of securities offered for sale. These credit ratings are based on the likelihood each class of securities will receive full and timely payment of all principal and interest it is scheduled to receive. The underwriters market and sell differently rated securities to different investors based on the investor's risk tolerance and the protection from losses afforded to a particular class of securities through credit enhancement.

Working with the underwriters, the rating agencies analyze the financial characteristics of the underlying loans to determine the likelihood of default and estimates of losses in a pool, and set credit enhancement levels to protect senior securities from losses on the underlying loans. Typically, the total amount of credit enhancement required by credit rating agencies is an indication of the risk associated with the underlying loans.

Subprime mortgage and asset-backed securities may have ratings based on transaction structures that rely on extensive amounts of credit enhancement. Credit enhancement comes in various forms, including overcollateralization, "subordinated" classes of securities, bond insurance policies, reserve funds, and "interest only" securities.

Before investing in subprime mortgage-backed securities, or securities targeted to areas with populations at risk, investors should ask the underwriter to compare the total credit enhancement required for the securitization to the amount of credit enhancement required in other sub-prime or similar securitizations. If disparities exist, ask the underwriter whether there is any likelihood the loans exhibit predatory characteristics. Ask about:

✔ *Collateral:* In over-collateralized deals, underwriters structure the transaction so that a greater amount of loan balances underlies the total amount of securities sold.

✔ *Subordinated securities:* Frequently, in addition to high-rated securities, underwriters will sell several classes of lesser-rated, subordinated securities that are used to absorb all losses on the underlying loans in the transaction.

✔ *Bond insurance:* Issuers of subprime mortgage-backed securities also may be required by the rating agencies to obtain an insurance policy that guarantees the senior-rated securities against losses from the underlying loans

✔ *"Interest only" securities/ reserve funds*: Reserve funds of special classes of "interest-only" securities, created from mortgage loan interest rates that are significantly above prevailing market rates, may be pledged as an offset to credit risk on the underlying loans.

Part Four: Conclusions

The consideration of a financial institution's investments and loans during safety and soundness or compliance examinations may be adversely affected by the predatory practices of other parties. This possibility is minimized through a risk-based due diligence focusing on the business practices of loan originators and the actual loan products packaged for sale or securitized.

A properly focused investigation before purchasing loans or investing in mortgage-backed securities can be cost-effective in minimizing the risks of becoming involved with predatory lending. Every institution should decide for itself precisely how and to what extent it will undertake due diligence related to these risks.

As the suggestions in this guidance may involve more effort than has been the practice in such business ventures, it makes sense to seek ways to limit undue burden and expense through a streamlined risk-based approach. It also makes sense to ensure the prospect of a predatory due diligence review does not have the unintended consequence of disrupting the flow of legitimate credit, in particular to under-served areas. For these reasons, we seek public comment on this draft staff guidance.